

February 28, 2006

TESTIMONY OF RICHARD OWEN

HB 488 / SB 305 TO THE HOUSE SPECIAL COMMITTEE ON OIL AND GAS  
AND SENATE RESOURCE COMMITTEE

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Mr. Chairman, members of the committee

Good afternoon. My name is Richard Owen and I am the Production Manager for ExxonMobil in Alaska and a vice president of ExxonMobil Alaska Production. Along side me, to assist in addressing any questions that you may have, are Marty Massey and Dan Seckers. Marty Massey is ExxonMobil's Joint Interest Manager for the U.S. and is leading our Alaska Gas Pipeline Project fiscal contract negotiations. Dan Seckers is our Tax Counsel responsible for Alaska.

I am here today, at your request, to offer ExxonMobil's thoughts and concerns about HB 488/SB 305. If this measure was simply a tax increase, ExxonMobil would actively oppose it. At current prices, we expect ExxonMobil's production tax payments would increase by \$50-\$100 million per year. However, we are prepared to move forward under the proposed system since it balances revenues to the State and producers across a range of oil prices, provides incentives for new investment, and includes a transition provision for recent investments. Most importantly for ExxonMobil, the PPT proposal provides a predictable and durable tax system which, along with the appropriate gas pipeline fiscal

contract terms, will allow the Alaska Natural Gas Pipeline project to move forward to the next phase.

As far as specific concerns about this bill, they center around whether the high tax rate and resulting increase in taxes will hinder full development of the remaining oil resources on the North Slope. I'll expand on this concern during my testimony. Before I make further comment on the PPT bill, I would like to give a brief overview of ExxonMobil's presence in Alaska and review how the current ELF system has benefited both industry and the State of Alaska.

### **ExxonMobil in Alaska**

ExxonMobil has had a presence in Alaska for over a half century, investing more than 11 billion dollars in the State's economy. Our activities date back to 1954 when we conducted a comprehensive study of the territory's oil and gas potential. Over the years, we explored most of the major hydrocarbon plays in Alaska including: the Gulf of Alaska; St. George and Navarin Basins; the Norton Sound; the Beaufort Sea; the Cook Inlet; and of course, the North Slope where we were a participant in the 1968 Prudhoe Bay State #1 discovery well. We are proud of the role our company has played in Alaska through: exploration; initial field developments; construction of TAPS; development of new technology; and the promotion of efficient reservoir management practices.

Currently, ExxonMobil has working interests in Prudhoe Bay, Kuparuk, Endicott and Granite Point. We are the operator of the Point Thomson Unit, and the largest interest

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holder in the Prudhoe Bay field. Our current working interest oil production is approximately 180,000 B/D (*Note: EMWI; 159,000 EMNI*) and we are the largest owner of discovered gas resource. Our production from Alaska represents approximately 4% of ExxonMobil's worldwide oil and gas production. Our Alaskan production is primarily from Prudhoe Bay and near-by satellite fields. Prudhoe Bay, along with Point Thomson, has significant remaining potential but it comes at higher cost and risk.

### Historical Context

One of ExxonMobil's objectives in both the gas pipeline fiscal contract negotiation and the debate on oil taxes has been to reduce the risk associated with fiscal changes by working with the State of Alaska to establish a predictable and durable fiscal environment in which to make long term investment decisions. To that end, any change in the fiscal regime for oil has a direct impact on how we view the stability of the Alaskan fiscal environment, which in turn, impacts how we evaluate ongoing investment decisions.

We understand the State's desire to obtain additional tax revenue at higher prices. One of the most challenging tasks that the Legislature can undertake is how to change the oil tax system without damaging the industry. As Governor Murkowski has correctly stated on many occasions, the North Slope is one of the most expensive places in which our industry operates. Tax systems need to be carefully designed to ensure that the desired objectives are achieved and that any change does not result in unintended consequences, such as reduced investments and lower reserve recovery.

One of the many questions that we are asked is, why are ExxonMobil and other Producers seeking durability and predictability for oil in parallel with negotiating a fiscal contract for a gas pipeline? The answer is fairly simple, the gas on the North Slope is contained in the same reservoirs as the oil and is produced through the same facilities. For a gas project to be viable, we need the fields that produce both oil and gas to be viable, underpinned by predictable and durable fiscal terms. A commitment of billions of dollars to build the natural gas pipeline requires confidence that the base oil business will remain healthy for the long-term.

#### Existing System – ELF

With that context in mind, I'd like to make a few comments about the current oil production severance tax system – the Economic Limit Factor or ELF and, in particular, how it has been effective at encouraging investment and mitigating production decline. The ELF was designed to allow the State to increase the production tax while not stifling investment in marginal fields. The ELF scaled down the production tax rate when a field became more marginal, reducing the economic limit to which a field could be produced and ultimately allowing more reserves to be recovered. The 1989 ELF amendment significantly increased the production tax on Prudhoe Bay and Kuparuk, while providing an incentive to encourage the development of smaller fields. That 1989 amendment worked as intended, with many small and marginal fields coming on stream over the past 17 years. The ELF lowered the tax rate on those fields, supporting their commercial viability.

While we would like to have more Prudhoe Bay's and Kuparuk's, we and the rest of industry haven't found any. Consequently, the focus for the past ten years has been on the development of these smaller satellite fields. Satellites are generally not economic as stand alone developments and have required both new technology and connection to existing infrastructure to be commercially viable. Many of these fields produce viscous oil contained in lower quality reservoirs requiring significantly higher costs which adds to the risks for development. This is especially true for the Polaris and Orion viscous oil developments, with oil that literally flows like "molasses." Developing these fields has required new technology, more expensive drilling and completion techniques, new production-handling equipment and extensive modifications to existing facilities to process these viscous production streams.

Since 2000, ExxonMobil has invested over \$250 million in the engineering, drilling, and construction of associated facilities for the development of Aurora, Borealis, Midnight Sun, Polaris, and Orion. Significant additional capital is required over the next several years to fully develop these resources. Today these fields are mitigating the decline of oil production on the North Slope, contributing 50,000 B/D gross and are expected to recover over 500 million barrels gross.

Under the ELF formula many of these smaller satellite fields paid little or no production tax. Even though these fields were paying little production tax they did, and continue to,

contribute substantial amounts to the State in royalties, property taxes and income taxes, and in jobs for Alaskans.

Over the past five years, we and other working interest owners have also extended the primary Prudhoe Bay enhanced oil recovery (EOR) technology to the some of these satellite fields. Since 1998, ExxonMobil has invested over \$30 million in tertiary recovery projects at Point McIntyre, Eileen West End, and Borealis which are expected to produce an additional 60 million barrels gross. While tertiary projects recover additional oil, the production profile results in a slower oil recovery and longer payout periods. These satellite EOR projects are in the early stages of development. The major investments have been made, but the oil production benefits will not be received until many years out. The ELF provision of the existing production severance tax made these economically challenged projects commercially viable.

Taken together, the recent Prudhoe Bay satellite and EOR development projects developed over 560 million barrels gross. While the resulting State's production tax under ELF was relatively minor, the State's royalty oil would total 70 million barrels, which at today's oil price is worth roughly \$4 billion. Bottom line, the ELF system has worked well for industry and the State of Alaska by encouraging significant new investment.

However, it is also recognized that ELF can be considered a somewhat regressive system in that it does not reflect "profitability" or "cost" in the division of gross revenue between

the State and the producers as oil prices rise and fall. The assumption that a well is marginal at 300 BOPD does not necessarily hold in the current high oil price environment, yet this assumption typically contributes to a reduced ELF factor based on the current formula. As a global oil and gas producer, ExxonMobil operates across a wide array of fiscal systems. It is most important that the system recognize the quality of the resources so that the potential developments will be commercially viable and attract capital. When I say the quality of resource, I mean: the size and nature of the oil and gas reservoirs, the cost and technology required to develop those reservoirs, the distance to market, as well as the tax and royalty system that applies including the long-term stability of that system. Countries that are experiencing significant industry investment have achieved the proper balance in their fiscal regimes.

#### **Alaska Remaining Oil Resource Base**

ExxonMobil's assessment of the remaining oil resource suggests future growth opportunities will come from: complex enhanced oil recovery (EOR) projects; development of smaller, more marginal oil accumulations; and the innovative development of viscous and heavy oil resources. These opportunities will require the development and application of new technology, higher unit development costs, and more complex operations to deliver a given production rate. These resources are much lower in quality as compared to Prudhoe Bay and Kuparuk, though they face the similar challenges associated with arctic conditions and distance to market.

Therefore, as stated earlier, we are concerned that the Administration's proposal is weighted towards a higher tax which may prevent some of Alaska's challenged resources from being developed.

**PPT Proposal - Overview**

I would now like to make some comments on the Administration's PPT proposal. This proposal represents a tax based on profits which results in a sharing of the risks and the rewards across a range of prices. The State will receive a higher share of the revenues when prices are high and will accept lower taxes during periods of low prices. The proposal moves from the regressive ELF system to a progressive system. ExxonMobil affiliates have significant experience in profit-based progressive systems around the world and they work well, as long as they have properly taken into account the nature of resource base – which I mentioned earlier.

Let me discuss some of the key features of the PPT proposal:

**PPT System: Transition**

This bill represents a major step-change in Alaska's current production tax system. The bill appropriately addresses this step-change by including a transition plan so that recent investment decisions are not adversely impacted. The bill provides a transition allowance over the next six years based on capital investments made in the last five years. We believe this transition plan is appropriate because the benefits from these recent investments have not yet been fully received. Oil and gas companies invest large sums of

money years ahead of first production and are at risk for price, development cost, production rates and ultimate reserve recovery. In most cases it takes many years, often more than five years, for a return on oil or gas investment to occur.

For example, satellite and tertiary recovery investment decisions during the last five years were made under the ELF structure anticipating a lower tax relative to that proposed under the PPT bill. The State appropriately provided this incentive so that these challenged and costly projects would be commercially viable. It is not appropriate to suddenly increase taxes on these investments without providing some form of consideration. The transition provision recognizes that past investments were made under the ELF structure and somewhat reduces the increased tax treatment to which these projects will now be subjected. To avoid penalizing these recent investments, the transition provisions included in this bill are essential.

**PPT System: Tax Rate and Investment Tax Credits**

As I have said, we are concerned the 20% tax rate as proposed will not support the growth opportunities remaining on the North Slope which I've described as primarily: complex enhanced oil recovery projects; development of small oil accumulations; and innovative development of viscous and heavy oil resources – these opportunities have challenged economics. While the investment tax credits of 20% will enhance the present value economics of new investments, the 20% tax rate will result in lower overall cash flow. The impact on all economic parameters must be carefully weighed before a decision to progress an investment is made. The combination of a 20% credit along with

a 20% tax rate may not be adequate to support development of all of the remaining opportunities.

It is with this in mind that we strongly recommend that the legislature not increase the proposed tax rate or reduce the proposed tax credits.

**PPT System: Valuation from Royalty Settlement Methodology**

This bill addresses many of the longstanding issues that have divided the State and the industry over the years. For example, too many years and too much money have been spent in disputes over how to value a single barrel of crude oil or a single molecule of gas. It made little sense in the past and it makes little sense today for the State to have separate divisions determining the value of oil and gas – one for royalty and one for taxes. There is only one value in the market place. HB 488/SB 305 allows the State to value a producer's oil and gas using the producer's royalty settlement agreement, which was negotiated with, and approved by, the Department of Natural Resources. This will provide certainty to a producer on the value on which to pay its royalty and production taxes and will reduce the administrative and audit costs to both the State and the industry.

**PPT Proposal - Conclusion**

Under current prices, ExxonMobil and industry will pay more in taxes as compared to the current production tax system. However, as I said in my opening comments we need predictably and durability under which to gauge investment decisions. No one wants to invest money in a project only to have the rules changed, reducing the attractiveness of

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the investment. The transition provision is an important feature of the bill necessary to provide relief for the abrupt change caused by the new PPT system.

The Administration decided to weight the proposal to a higher tax which may make it difficult to progress the remaining future development opportunities. It is most important that the quality of the resources be factored into the design of the tax system. Given our view of the resources, we would not support a higher tax rate or lower credits than proposed in the bill.

HB 488/SB 305 seeks to balance revenues to the State and the producers across a range of oil prices and provides incentives for new investments, which is a clear objective of the State of Alaska.

And most importantly for ExxonMobil, we believe the new system, coupled with appropriate gas pipeline fiscal contract terms, will lead to a predictable and durable tax system, which will enable the Alaska Gas Project to move forward to the next phase. Potential changes to the features of the PPT bill must be carefully considered to avoid upsetting the balance contained within the bill.

In conclusion, this bill is important for Alaska and the Producers. It is one part – a very important part – of a series of related issues that the legislature will need to address to ultimately provide the necessary fiscal environment to stimulate oil production and to progress the Alaska Gas Pipeline Project.

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The Fiscal Contract that is being finalized under the authority of the Stranded Gas Development Act will incorporate this PPT legislation by reference in order to provide fiscal stability. We are currently working with the Administration on how best to incorporate this bill into the fiscal contract.

The Fiscal Contract will soon be released for public and legislative comment. Following the regular session, we understand the Governor will call a special session so the Legislature can vote on the contract. For that reason it is important that HB 488/SB 305 be enacted in its present form prior to that special session.

ExxonMobil has been in Alaska for over 50 years. Our future business plans show our continued activity in Alaska for at least the next fifty years. We are on the verge of taking the next step to commercialize Alaska's North Slope gas and I ask you to support the Administration's efforts in this regard.

Thank you again Mister Chairman for the opportunity to testify today.